Integrating Government Compliance Requirements with Commercial Business Realities

A Candid Look at Commercial Business Practices — Non-Government Business vs. Business Under a GSA Schedule Contract

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As a result of the emphasis placed on commercial practices and a relaxation of the old government regulatory rules that forced companies to develop customized pricing, accounting, invoicing, and data accumulation systems to conform to strict government requirements, companies that ordinarily produce and sell only commercial products in the commercial arena have been scrambling to sell their products and services to the Federal Government. The avenue for gaining entry to the government marketplace has often involved the commercial company acquiring a General Services Administration (GSA) Schedule Contract in which to place a never-ending list of products and services for government agencies to peruse and order.

However, this new emphasis on commerciality has not come about without its own unique and little understood set of problems. Those companies seeking to do business with the Federal Government must be aware of and avoid regulatory and legal entanglements that can easily adversely affect their government business and cause them to run afoul of the Federal Acquisition Regulation (FAR) as well as other non-FAR legalities.

This article identifies the interaction between commercial practices involved with non-government business and government business under a GSA Schedule Contract. It discusses the general compliance requirements of GSA business and the nexus and influence of non-government business practices and also illuminates the importance of keeping one balanced by the other.

Avoiding the Pitfalls and Liabilities

The responsibility for compliance with GSA's regulatory requirements should be considered and treated as part of the various legal responsibilities with which a corporate business entity must recognize and comply. While the generic federal business unit should have primary responsibility to respond to this challenge, this responsibility should be shared among all business segments. The corporate commercial product groups should be keenly aware of the legalities involved in this aspect of their business (selling their products to the government through this contract vehicle) and take them into account when making business decisions in their respective competitive commercial environments. Such due diligence will go far in avoiding internal conflicts and government compliance problems.

The legalities of GSA compliance are not the only legal constraints that are imposed upon corporate business activity and behavior by our body of state and national laws. Other laws govern corporate business decisions in ways such as how corporations compete with one another, deal with individuals, dispose of waste products, or even engineer products that are accessible to people with disabilities.

A better understanding of the legalities associated with GSA compliance will make it easier for a business to avoid the pitfalls and liabilities of violations. A better understanding will also serve to create a strong bond of teamwork and coordination for expanding business across all business sectors in much the same way that a corporation responds to other legally imposed constraints.

Fair Dealing

The basic rule of GSA compliance is fair dealing. GSA expects and legally requires that a business provide accurate, current, and complete information about its business practices with respect to its commercial distribution channels. What this legal requirement amounts to is a full disclosure of the terms and conditions of its distributor, reseller, and major end-user agreements to determine or establish a "basis of negotiation" for the terms and conditions of a GSA contract. In other words, it is GSA's way of finding out how a company conducts its business affairs in the commercial envi-

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ronment so that they (GSA) have some leverage in negotiating with the commercial firm. Disclosure not only establishes a fair business relationship, but also takes into account the government's dollar volume and embraces fair and reasonable prices.

Basis of Negotiation

Since the government considers itself to be a large end-user customer, the basis of negotiation is quite often formulated on the relative distinctions in discounts that the company maintains among the different categories of commercial corporate customers; and the relative differences between the terms and conditions that are maintained among the company's distributors vs. resellers vs. end-users. (Another term that is used for this in the commercial marketplace is "vertical price maintenance" or "channel alignment," wherein a manufacturer would ordinarily grant a larger discount to a distributor vs. an end-user.)

Once this "basis of negotiation" is established for a GSA Contract, GSA expects it to remain fixed for as long as the contract is in place, unless disturbed by a change in corporate commercial business practices. Major deviations or changes to the underlying commercial relationships, in turn, give GSA justification to insist on changes or adjustments to the basis of negotiation. Changing or adjusting the basis of negotiation in effect brings it into line with the new set of relative distinctions in the corporation's commercial relationships. A classic example follows:

A manufacturer has established a dual distribution channel for marketing and selling its products through wholesale distributors, resellers, and direct sales to end-users. The pricing mechanism it has decided to use is to establish list prices and grant a fixed discount to each class of customer. It will grant a discount of 30 percent off the list price to its distributors, a 25 percent discount to its resellers, and an 18 percent discount to end-user customers. In its negotiations with GSA to establish a basis of negotiation, the relative difference between the distributor discount and the end-user discount—30 percent minus 18 percent, or 12 percentage points—will be pegged as a reference point in negotiating the discount for the GSA Contract.

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If the manufacturer caused this reference point to change by increasing its discount from 18 to 20 percent to its end-user customers during the term of the GSA Contract, it would be required by regulatory law for the manufacturer to report the change(s) to GSA. This disclosure would then be used by GSA to determine whether the government should receive the same discount increase for the same products that the manufacturer sold commercially at the lower price.

The Price Reduction Clause

The Price Reduction Clause, which is in all GSA Schedule Contracts, can also be explained in a basic, straightforward manner.

Negotiation and award of GSA multiple award schedule contracts are normally conducted on the basis of discounts from an established commercial price list. From this list, substantial sales are made to the general public at the published prices. Once this information is received, GSA uses it to identify a certain category of customer and to establish a "basis of negotiation" relationship, which must be maintained throughout the contract period. Any change in the company's commercial pricing practices or discount arrangement applicable to this identified category of customer (known as the *tracking customer*) that *increases* the established discount will constitute a price reduction and possibly trigger the Price Reduction Clause.

When the provisions of the Price Reduction Clause are invoked, it has the practical effect of rolling back prices for products that have been sold to the government under the GSA contract at the higher price. Such rolling back is effective from the time the established commercial discount applicable to the *tracking customer* was *increased,* through the current date and continuing until the end of the contract term. This rolling back of prices will create a government monetary claim against the company for the cumulative amount of government overpayments, which the company will have to satisfy by writing a check. Credit memos are unacceptable in this case.

While regulations require government contractors who have GSA Schedule Contracts to disclose all events that would potentially disturb the basis of negotiation within 15 days of their occurrence, some contractors do, in fact, fail to observe this performance requirement. However, if the government does not find out about these events until its auditors perform an official audit (and they will perform one sooner or later), the monetary claim will be larger, and other noncompliance penalties could be assessed for failing to self-disclose.

Reporting Requirements

Several contract clauses or GSA regulations require a company to make reports to GSA about the status of the basis of discounts during the contract period. As previously stated in this article, GSA uses the information provided by the company about the terms and conditions of its distributor, reseller, and major end-user agreements for the purpose of determining or establishing a "basis of negotiation" for the terms and conditions of the GSA contract.

Once the basis of negotiation is established and used to identify a category of customer (i.e., distributor, reseller, or end-user), a contract award is made. The category of customer identified during the disclosure and negotiation process will be *tracked* during the entire contract period to determine whether the government's discount relationship to the category of customer changes in any significant manner. Any *increase* in the original discount arrangement with the identified category of customer that disturbs this relationship will constitute a price reduction.

During the contract period, the company is required to report to GSA all price reductions to the category of customer that was the basis of contract award. The company's report is required to include an explanation of the conditions under which the reductions were made *if* the company took any of the following actions:

- Revised its commercial catalog, price list, schedule, or other document upon which the contract award was predicated to reduce its prices to the category of customer.
- Granted more favorable discounts or terms and conditions than those contained in the commercial catalog, price list schedule, or other documents upon which contract award was predicated.
- Granted special discounts to the category of customer that was the basis of award, and the change disturbs the price/discount relationship of the government to the category of customer that was the basis of award.

The response time for making such reports to GSA is within 15 calendar days after the effective date of the price reduction.

Country of Manufacture

The body of government regulations that restricts the government from purchasing end-item products manufactured in certain countries is known as the Buy American Act (BAA) and the Trade Agreements Act (TAA). These laws, in a manner of speaking, act as national and international socioeconomic programs.

Buy American Act. The basic intent of the BAA legislation is to provide a preference, with respect to the government's expenditure of taxpayer dollars, for domestic end-products over foreign end-products. In practical terms, this boils down to the government using taxpayer dollars to buy products that are manufactured in the United States. Such products are not only manufactured in the United States, but their cost content of domestic components must exceed 50 percent of the cost of all the components, so as to maximize the economic benefit for U.S. citizens and manufacturers. Labor and facilities' costs may be included in the 50 percent total manufacturing cost threshold.

Trade Agreements Act. When it's impossible for the government to find U.S. domestic end-products that satisfy its needs and still meet the BAA restrictions, the TAA allows the government to spend the taxpayer's money to benefit the citizens of America's trading partners. These partners are signatories to certain treaties, namely The Agreement on Government Procurement, as approved by the U.S. Congress in the Trade Agreements Act of 1979, and amended by the Uruguay Round Agreements Act. The signatory countries to these treaties and agreements are generally considered friendly to the United States, and their products therefore qualify for an exception to the government's preference to procure only domestic end-products. These exceptions are referred to as "designated," "qualifying," "NAFTA" [North American Free Trade Agreement], or "Caribbean Basin" end-products.

A few examples of the countries that are not signatories to these treaties and agreements are Malaysia, Taiwan, Peoples Republic of North Korea, Peoples Republic of China, Cuba, Iran, Iraq, and Sudan.

Ordinarily, the BAA applies to government purchases of supplies and services that are greater than $2,500, but less than $186,000 (subject to annual adjustment), while imposing a strict requirement that more than 50 percent of the cost of each end-product be attributable to manufacturing or production activity in the United States.

The TAA applies to all contracts in excess of $186,000 (subject to annual adjustment). It allows for products made in certain countries to be considered the same as domestic products. These countries are those that have signed the Government Procurement Code under the World Trade Organization (WTO), Caribbean Basin Trade Initiative, and NAFTA. However, the dollar threshold for application of the TAA is subject to the policy set by the U.S. Trade Representative. For example, the dollar threshold that applies to NAFTA contracts is $53,150. None of these laws apply to small orders less than $2,500 in value, referred to as micro-purchases.

Substantial Transformation Rule

The TAA allows a significant exception to the greater than 50 percent rule by creating a process known as the "Substantial Transformation Rule." The Substantial Transformation Rule allows the government to buy commercial end-products comprised of parts, components, or subassemblies that have been purchased by signatory countries (United States included) from *non*-signatory countries, provided that the signatory country has added sufficient costs and materiality such as parts, components, labor, or facilities during the manufacturing or production process.

End-products bought in this manner, however, must constitute a new and different article of commerce with a name, character, or use distinct from that of the noncompliant, *non*-signatory country end-products from which they derive. (In other words, a signatory country can take *some* noncompliant parts and components from *non*-signatory countries; add a good measure of compliant parts and components, labor, and facilities costs; and create an end-product distinct from its individual parts, which will be a TAA-compliant product.) This is the exception that governs many sales to the government through the GSA business channel, whether via federal resellers or direct GSA Schedule Contract sales.

Of course, the law provides for the government to assess or impose penalties on companies that fail to observe and comply with the regulatory requirements of the TAA. That is the primary reason that companies with a heritage of leadership in government service and participation in the Reagan-appointed Packard Commission maintain a diligent and vigilant effort to keep track of the manufacturing origin of the products they offer for sale. In the words of the Packard Commission's Interim Report of Feb. 28, 1986:

> "To assure that their houses are in order, defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance."

Channel Conflicts to Avoid

Most contracts with GSA require most favored customer pricing. That is to say, the company must offer GSA the best pricing afforded its end-user customers, given a few exceptions. A departure from offering only published discounts is justified under certain conditions, such as:

Meeting Competition. Granting preferential terms, pricing, or promotional services and allowances to a commercial customer for the purpose of meeting competition in a competitive program will generally result in no violation of GSA's rules associated with the basis of negotiation and price reduction clause, since meeting competition is a recognized defense to anti-price discrimination statutes in general. To document such actions, sales personnel should obtain sales management approval for such competitive concessions and proof of the competitive offer before granting such concessions. A competitive offer report containing information about the competitive offer should be prepared and submitted prior to authorization.

Restricted or Special Product Offerings. Restricting special preferential terms and pricing to a small subset of products, or special configurations that are customized only for a particular customer, may also serve as a defense against allegations of violating GSA's basis of negotiation rules, price discrimination, or unfair treatment since the preference involves a relatively few, specially configured products that would only be sold to a particular customer. This defense alone, however, is not sufficient to establish a strong defense against such liability. It should be combined with the next two conditions: Significant Minimum Purchase, Accelerated Delivery; and Exclusivity.

Significant Minimum Purchase, Accelerated Delivery. Significant volume within this context means that the commercial deal will involve preferential terms and pricing and will be a transaction of sufficient magnitude (in terms of minimum quantity *and/or* minimum dollar value to be purchased) to exceed any reasonable expectations that it would be matched by the customer's competitors, or GSA. Accelerated delivery means that the minimum required purchase volume would have to be ordered *and* delivered within a relatively brief time frame. To refute the scrutiny and allegations that the agreed-upon minimum purchase commitment is only a nonbinding sham that looks good but has no real consequences for noncompliance or breach of contract, the transactions agreement should include contractual remedies for the company in the event the customer does not meet or fulfill the minimum purchase requirement.

Exclusivity. The last generally recognized condition — needed along with the other three conditions to form an adequate defense against price-reduction allegations by GSA; liability from federal anti-price discrimination and unfair treatment statutes; and customer satisfaction issues in general — is *exclusivity*. Exclusivity in this compliance outline means that a material condition of the deal, expressed in the transaction agreement or contract, is that the customer receiving the preferential terms and pricing will be committed to purchasing the subject products only from the company named in the contract during the agreement or contract term.

This requirement does not preclude both parties from continuing, in good faith, to renegotiate prices and terms periodically as market conditions dictate, during the contract period. But it does prevent the customer from "willy-nilly" walking away before the end of the contract period without cause, only to buy the subject products from a competitor.

Other Compliance-Related Issues

Promotions are generally special deals with regard to products, pricing, and any other combination of terms that are offered to *all* customers in a certain category for a limited amount of time. Promotions will not violate GSA's rule of fair dealing as long as they are made available on proportionately equal terms to GSA customers and involve products that are offered to all resellers or distributors of the same business classification.

Growth in Harmony With GSA

This article does not draw any conclusions, but rather seeks to illuminate and present a cogent and rational discussion of issues that few seem to sufficiently grasp. I suspect that this general lack of understanding results in a significant amount of frustration, lost effort, time, and money in attempting to understand, or to find someone else who understands and can clearly explain to corporate management, the intricacies of integrating government compliance requirements with commercial business realities. Hopefully, this article will help companies to grow their commercial business in harmony and concert with their GSA business — *not* at the expense of it.

Editor's Note: The author welcomes questions or comments on this article. Contact him at **tony_mackey@hp.com.**